Proposed Federal Legislation Regarding
State Business Activity Taxes (BAT)
Possible Board Action

In the last session of Congress, business interests sponsored legislation (HR 3320, Goodlatte) that would have created new limitations on State business activity taxes. It is anticipated that similar legislation will be introduced again in this session. Staff is requesting permission of the Board to participate in a joint state effort to oppose proposed federal legislation similar to last session's HR 3320.

Estimated Revenue Consequences

The department has estimated that the HR 3320 would cost California "income" tax revenue of $500 million annually by 2008-2009. The department has not estimated the losses of other California state taxes that would be affected.

State Legislation

AB 2061 (Haynes), patterned after HR 3320, was introduced in the California Legislature in the 2004 session. The Board did not take a position on the AB-2061.

Background

In 1959 Congress passed Public Law 86-272 (15 USC Section 381 et seq.) as a temporary measure to limit the States' ability to impose income taxes on interstate commerce. Public Law 86-272 forbids a state from asserting a tax on or measured by net income on a person who is not domiciled or resident in the state if the person's activities are limited to the solicitation of sales of tangible personal property with both the approval of the order and shipment or delivery of the goods occurring outside of the state. In addition, a state cannot assert such a tax if the person is represented by an independent contractor in the state even if the independent contractor maintains an office in the state. That law remains in effect today and is the only broad-based federal legislation limiting the States' taxing powers. Other federal legislation has been enacted that limits the States' ability to tax certain activities (Internet Moratorium) and industries (the "Four R Act" involving railroads).

In addition, the States' ability to tax interstate or foreign commerce is subject to judicial review under the United States Constitution by what is commonly referred to as a "dormant Commerce Clause " analysis. The "dormant Commerce Clause" analysis employs a four-part test with respect to interstate commerce in determining whether a state tax is permissible. The tax must: 1) be applied to an activity with a substantial nexus with the taxing state, 2) be fairly apportioned, 3) not discriminate against interstate commerce or in favor of intrastate commerce, and 4) be fairly related to the services provided by the state. (*Complete Auto Transit, Inc. v. Brady* (1977) 430 U.S. 274.) In the case of foreign commerce two additional elements are added. These elements are; the tax cannot give rise to an increased risk of multiple taxation, and it

must not prevent the nation from speaking with one voice in an area involving foreign relations. (*Japan Line Ltd. v. County of Los Angeles* (1979) 441 U.S. 434.) Numerous cases have been argued before the United States Supreme Court, and lower courts, where this test has been applied. State taxes are also frequently subject to judicial scrutiny under the Due Process Clause of the Fourteenth Amendment. State taxes may implicate other provisions of the United States Constitution as well.

One of the primary issues involved in dormant Commerce Clause litigation is what activities are sufficient to create the required nexus for a state to assert a tax. As our national economy has evolved, much more activity takes place through electronic media and involves the rendering of services and the sales of other than tangible personal property. In *Quill Corp. v. North Dakota* (1992) 504 U.S. 298, the United States Supreme Court distinguished Due Process Clause nexus from Commerce Clause nexus and held that for purposes of sales and use taxes a physical presence was required to allow a state to assert a tax. The Court's decision was grounded in the principle of *stare decisis* and a previous decision of the Court that a use tax could not be imposed on a mail-order seller. The States and taxpayers do not agree on whether the holding in *Quill* should be limited to sales and use taxes. The States and the taxpayers have been litigating the question of what presence is required for other taxes, and legislation has been considered to allow the states to assess sales and use taxes without requiring a physical presence. Several States have successfully asserted non-physical presence nexus in the context of other taxes, and the United States Supreme Court has declined to review these cases.

A chart comparing current federal law, Public Law 86-272, with HR 3320 is attached along with a more detailed discussion.

Also attached is an excerpt from an article by Professors Walter Hellerstein and Charles McLure that analyzes the BAT proposal.

Position of National Governors' Association

The National Governors' Association, in a letter dated September 24, 2004, stated that it was strongly opposed to the proposed legislation. The stated reasons for its opposition included:

> The proposal was not simple and would encourage non-uniformity;
>
> The proposal was not neutral and would give an advantage to interstate commerce *vis a vis* intrastate commerce;
>
> The proposal was effectively a "tax shelter;" and
>
> The proposal was not consistent with federalism.
>
> The proposal would result in the loss of 15% of state business activity revenues.

Comparison of HR 3320 to Public Law 86-272

	Public Law 86-272	HR 3320
Taxes Limited	Income Taxes	All State Taxes, except Transaction Taxes
Activities Protected	Only solicitation of sales of tangible personal property	All types of activities, absolute for Purchasing News coverage Meeting with government Education and training Charitable Activities Contract Manufacturing
Presence Allowed	Salesperson	Any non-physical presence Physical Presence 21 days or less. Exceptions allowing tax for less than 21 days Deliveries within state Servicing Real Property Entertainment Performance
Representation Allowed	Independent Contractor	Any non-exclusive agent

Detailed discussion of the HR 3320

H.R. 3220 would place significant new limitations on the ability of the states to impose taxes on or measured by income of individuals and corporations, if the taxpayer stays within the limits of several federal tax nexus "safe harbors." The legislation would significantly expand both the number and quality of contacts that an entity or individual can have in California and still be exempt from California taxation. Some of the safe harbors would even permit businesses to own property (in some cases, real property) in this state, for extended periods of time, without incurring a California tax liability. The most significant additions to exempt activities are:

1) Employees (of any number) can do any act or acts for an out-of-state entity so long as the activity is completed in 21 days or less per year.

2) Employees can be in this state on behalf of an out-of-state entity on a permanent basis for any of the following: purchase of goods and services in this state, gathering news for media distribution, meeting government officials, participation in training seminars, or charitable activity.

3) An agent (other than an employee) can do any act, except "establishing or maintaining a market," for an out-of-state principal, and that act will not impute tax nexus to the principal.

4) An agent can "establish or maintain a market" on behalf of an out-of-state entity without imputing nexus, so long as the agent solicits for 21 days or less. If, however, the agent acts for more than one entity, the agent may "establish or maintain a market" in this state for an unlimited number of days. It is not necessary that the agent be "independent."

5) An out-of-state entity can have an unlimited amount of inventory in this state, so long as the inventory is being assembled, manufactured, processed, or tested by a contract manufacturer or processor (including a member of the unitary group).

6) An out-of-state entity can have an unlimited amount of "tangible property" in this state, if that property is used by another entity (including a member of the unitary group) to provide a service back to the out-of-state entity.

7) An out-of-state entity can have an unlimited amount of property, including real property, in this state if the use of that property is "ancillary" to a protected activity.

As a result of these exemptions, some taxpayers, particularly members of a unitary group, would likely be able to create income that cannot be taxed by any state ("nowhere income") by creating "nowhere property, payroll, and sales" factors. There is some potential for recouping some of the lost revenue caused by the inability to tax

California destination sales, as a result of the "throwback rule." However, taxpayers could avoid throwback sales both by tax planning and by a simple lack of compliance.

If taxpayers maximize the planning opportunities that this legislation would permit, as a practical matter the sales factor may be meaningful only for corporations that provide a significant level of services in this state, that sell goods in stores at retail, or that have wholesale transactions with a large number of California customers. If this proposal became law, and if California were also to legislatively adopt a single sales factor apportionment, the problems presented by the bill could be much greater, and the risk to the state fisc much larger.

For personal income tax purposes, the bill also provides an opportunity for individuals (including, in some cases, California residents) to avoid California income tax, but only in limited circumstances. On the other hand, individuals that are involved in an apportioning trade or business (for example, a partnership or proprietorship that does business within and without the state) could employ some of the same techniques that would be available to corporations through the use of related partnerships.

Taxes Affected by the Bill.

Taxes On Or Measured by Income

Insurance Gross Premiums Tax

Minimum and privilege taxes

Expansion of P.L. 86-272.

The bill would prevent the taxation of most personal services if performed in 21 days or less. The bill would also prevent the taxation of a service where an employee entered the state to solicit a sale but provided the service outside of the state. In general, this would not presently affect California, because, for sales factor apportionment purposes, sales of *other than* tangible personal property are assigned based on the single state where the greater cost of performance lies (see §25136, Revenue and Taxation Code (hereafter RTC), and §17 of the Uniform Division of Income for Tax Purposes Act (hereafter UDITPA)), and presumably the taxpayer would have its property and payroll outside of the state.

Nexus Protections for an Absence of Physical Presence, as Defined.

Comparison to the Physical Presence Standard in Use Tax Case Law.

The definitions appear to restrain the state's taxing power much more than would the physical presence test under current judicial standards. They are, for example, a much broader limitation on state taxing nexus than the standard for physical presence under

judicial standards for sales and use taxes, which is largely based on a "more than de minimis" physical presence standard.

The 21-day "Any Activity" Exemption.

The bill essentially treats an individual's or an employee's presence in a state as not constituting physical presence if the individual or employee is in the state for 21 days or less, *for any purpose*. For personal income tax purposes, this provision would generally prevent California from asserting California tax on services performed within the state, if that performance is done in 21 days or less. For corporate income/franchise tax purposes, this provision would prevent California from assigning a sale to California, even if the greater cost of performance were in this state. In addition, there is no "throwback" mechanism in RTC §25136 for the sale of services.

Presence in the State for Purchase of Goods or Services.

The bill provides a total disregard of individuals or employees that are in the state for possible purchase of goods or services.

Gathering News and Covering Events.

Section 3(b)(1)(B) of the bill provides for a total disregard of employees in the state for gathering news or "covering events" for distribution in the media, regardless of duration. "The media" is not defined.

Meeting Government Officials.

The bill exempts meeting governmental officials for other than selling goods and services.

Educational and Training Seminars.

Section 3(b)(1)(D) exempts "participation" in educational or training seminars or similar conferences. This appears to include providing the education or training.

Actions By A Representative

A "Person" Acting on Behalf of More than One Entity.

An agent or contractor is disregarded if the "person" performs services for more than one business entity.

Acts by a "Person" after the Sale.

Because the imputation of nexus is limited to work to "establish or maintain the market," this provision would probably be construed to prevent the state from asserting nexus

against a company that hires an independent contractor engineer to provide "after market" support services to property or services previously sold. This provision (in conjunction with the expansion of the protections of P.L. 86-272 to services and intangibles) appears to be a "roll back" of established constitutional nexus standards that would impute the sales activity of independent contractors to the party for which they perform services (*Scripto v. Carson, Inc.* (1960) 362 U.S. 207).

The Assembly, Manufacturing and Processing Exemption.

Section 3(b)(3)(A) provides a total exemption for "tangible property" in the state for purposes of being assembled, manufactured, processed, or tested by another "person" for the benefit of the owner.

Property In The State

Use of an Owner's Property in the State to Provide a Service to the Owner by Another.

Section 3(b)(3)(A) also allows "tangible property" in the state to be disregarded if another "person" uses property of an out-of-state owner to furnish a service to that owner.

Marketing and Promotional Materials in the State.

Section 3(b)(3)(B) exempts marketing or promotional materials distributed in the state using mail or common carrier or as inserts in publications.

"Ancillary Property" in the State.

Section 3(b)(3)(C) exempts property used in the state *for any period* from being considered for tax nexus purposes, if that property is used in conjunction with activities *excluded* from the 21-day time limits for employees or acts by a "person" on behalf of an out-of-state entity.

Individuals

Domicile Versus Residence for Individuals.

Section 3(d)(1) removes the exemption for individuals that are *domiciled* in the state. Curiously, section 3(d)(1) of the bill does not follow the pattern of P.L. 86-272, which removes the exemption from individuals that are either domiciled in the state or a *resident* of the state.

Single Sales Factor-Only Apportionment.

There is a potential interactive effect of the proposed federal legislation with possible changes in California law. There is significant pressure in the California Legislature to

move toward a sales factor-only apportionment formula. That would result in a complete disregard of the payroll and property factor contributions of the related subsidiaries. If both proposals became law, there would likely be significant behavioral changes to organize corporate groups in a way to completely avoid tax, despite having substantial benefits and protections of the state.

Effects on Cities, Counties, and other "Political Subdivisions."

Section 4(3) defines a state to include political subdivisions of a state. Thus, all of the limitations described above would apply to cities, counties, and districts.

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SUMMARY:
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Congress is considering or is about to consider three significant pieces of proposed legislation affecting state taxation: a proposal to extend (and perhaps expand) the Internet Tax Freedom Act; a proposal to allow states to require collection of taxes on remote sales if they simplify their tax systems in accord with the Streamlined Sales Tax Project (the Streamlined Sales and Use Tax Act); and a proposal to expand nexus restrictions on business activity taxes. In this report, the authors consider the merits of congressional intervention to limit and expand state taxing authority from a tax policy perspective informed by a normative analysis of the appropriate role of the federal government vis-a-vis state taxing authority. Part I provides an overview of congressional intervention in state tax matters against the background of the historical, political, and constitutional understanding of state tax sovereignty. Part II provides an overview of the normative principles of tax policy that the authors believe, should inform congressional intervention in state tax matters in light of the background described in Part I. Part III describes the three congressional proposals at issue, elaborates on the key normative considerations that bear on them, and applies those norms in evaluating the proposals.

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Table of Contents

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issue, elaborates on the key normative considerations that bear on them, and applies those norms in evaluating the proposals.

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C. Business Activity Tax Legislation

1. The Business Activity Tax Simplification Act. Legislation has been introduced in Congress limiting the states' power to impose business activity taxes (BATs). The proposed legislation would prevent the states from imposing net income taxes or other "direct" taxes on business activity (for example, gross receipts taxes) unless the taxpayer satisfies the statutorily prescribed nexus requirements. The most significant of those requirements are a physical presence requirement (exceeding 21 days of physical presence). In substance, the legislation expands the requirements of Public Law 86-272, which imposes limited nexus requirements regarding net income taxes on income from the sale of tangible personal property, to any BAT on any form of business activity (including the sale of services and intangibles), and provides a number of safe harbors for physical presence (for example, the 21-day requirement, activities in connection with the possible purchase of goods or services, and participation in educational or training conferences).

2. Principal normative consideration bearing on nexus for BAT legislation. As in the discussion of ITFA and SSUTA, we begin by asking what nexus standards would be appropriate under an ideal tax regime -- in this context, one in which all states used the same income attribution rules. Then we ask what nexus rules would be appropriate under the more realistic assumption that the tax regime is less than ideal -- namely, that income attribution rules are not uniform.

a. Uniform income attribution rules. Corporate income should be subject to tax in the state where it is earned, at rates chosen by the state. It is, however, generally not realistic to try to use geographic separate accounting to determine the source of income for a corporation that carries on integrated economic activities across state lines. Leaving aside the obvious fact that corporations do not keep books on a state-by-state basis and should not be required to incur the enormous compliance costs required to do so, geographic separate accounting would fail to take account of the economic interdependencies between activities occurring in different states and would be vulnerable to manipulation of transfer prices on transactions occurring within the corporation to shift income to low-tax or no-tax states. The states have long used formulas to apportion business income, by far the majority of corporate income, between in- state and out-of-state activities. Some states combine the activities of affiliated corporations deemed to be engaged in a unitary business for two of the same reasons they use formula apportionment: economic interdependence and difficulties of transfer pricing.

The choice of apportionment formulas (including the weights to put on the various apportionment factors) and the definition of each of the factors are to some extent arbitrary, as are the definition of apportionable income, the exact standard to use in determining the contours of a unitary business, and administrative procedures. However, it is clearly advantageous for all states to define apportionable income in the same way, use the same apportionment formula, define the apportionment factors in the same way, use unitary combination, use the same definition of a unitary business, and use the same administrative procedures. Uniformity would minimize compliance costs and prevent gaps and overlaps in the tax system, with the attendant inequities

and distortions. Combination, rather than separate-entity accounting, is required to combat tax planning and prevent loss of revenue. With uniform income attribution rules and administrative procedures, a single spreadsheet would provide a comprehensive division of income of the relevant corporate group among the states, including those that have no income tax, and there would be little or no need for nexus rules. Introduced into that environment, a nexus threshold like that embodied in Public Law 86-272 would, in the first instance, almost certainly create "nowhere income" -- income attributed to states that lack jurisdiction to tax it -- and a high nexus standard would probably lead to suggestions for ways to prevent this from happening, such as excluding the taxpayer's factors in the state where it lacks nexus from the denominator of the apportionment formula.

Uniform income attribution rules are necessary for a satisfactory solution, but they are not sufficient. Even if income attribution rules were uniform, there might be adverse economic consequences, opportunities for tax planning, and nowhere income; those possibilities would depend on the rules chosen. For example, if the uniform rules included apportionment based solely on sales, a nexus standard based on anything but a sales threshold would have this effect. This can be illustrated by the interaction of Public Law 86-272 and uniform adoption of sales-only apportionment. Under this regime a corporation would pay little or no BAT in a state either (i) if it had substantial sales in the state, but could take advantage of the Public Law 86-272 safe harbor, or (ii) if it had a substantial physical presence but only minimal sales.

b. Diverse income attribution rules. The BATs currently levied by the states often provide substantially different solutions to the problem of attributing income to its source. Definitions of apportionable and allocable income differ. Some states do not require combination, and those that do often have inconsistent definitions of the combined group. Nor do all states use the same apportionment formula or define the apportionment factors (especially sales) in the same way. Finally, administrative procedures are not uniform. The result is complexity, gaps and overlaps in taxation, adverse economic effects, opportunities for tax planning, and loss of revenue. While a nexus threshold is arguably appropriate under these circumstances to reduce complexity, a badly chosen threshold will aggravate the other problems, just as with uniform income attribution rules.

The only persuasive justification for nexus rules is to ameliorate complexity -- to avoid payment or collection of taxes when the revenue involved is not worth the cost of compliance and administration. That implies that nexus rules for BATs should take account of the taxpayer's apportionment factors in a state -- that is, if a taxpayer does not have at least one factor in the state that exceeds a certain threshold, stated alternatively as a minimum dollar amount or a minimum fraction of the taxpayer's total of that factor, it should not be liable for BAT in that state. Conversely, if it exceeds the threshold for at least one factor that appears in the state's apportionment formula, it should be deemed to have nexus for BAT in that state.

How high nexus standards should be depends on how much diversity there is in the state BATs. If there were little or no diversity, the standard could be quite low or nonexistent, as noted earlier. On the other hand, substantial diversity would call for a much higher standard. That implies that if the states want the Congress to enact a low nexus standard for BATs, they should be required to substantially reduce the diversity of their taxes.

3. Evaluation of proposed BAT legislation. As noted earlier, legislation has been

proposed that would expand the nexus protection provided by Public Law 86-272 by making it applicable to income from any type of sales (not merely sales of tangible products) and specifying activities that could be conducted in a state without creating nexus for BAT. In other words, it specifies that a physical presence is required to create nexus; sales are not enough.

The proposed legislation is clearly inconsistent with the normative considerations delineated above. It would expand the scope for the creation of nowhere income, and thus aggravate the opportunities for tax planning and the revenue loss created by Public Law 86-272. This is especially true in states where sales are the only or primary factor used to apportion income -- a rule that has been advocated by many of the same business interests that are seeking a physical presence nexus rule for BAT.

Beyond the normative considerations that we believe should shape congressional policy regarding nexus for BAT purpose, we believe it important to identify and discuss several unsound arguments that are often heard in the current debate. The following excerpt from a policy statement by the Council On State Taxation (COST) is representative of one such view:

> Determinations of jurisdiction to tax should be guided by one fundamental principle: a government has the right to impose burdens -- economic as well as administrative -- only on businesses that receive meaningful benefits or protections from that government. In the context of business activity taxes, this guiding principle means that businesses that are not present in a jurisdiction and are therefore not receiving any benefits or protections from the jurisdiction, should not be required to pay tax to that jurisdiction.

This line of reasoning is indefensible, whether the benefits corporations receive are defined broadly, to mean the ability to earn income, or defined more narrowly to mean specific benefits of public spending, one of which is the intangible but important ability to enforce contracts, without which commerce would be impossible. A profitable corporation clearly enjoys both types of benefits. It is true that in-state corporations may receive greater benefits than their out-of-state counterparts, for example, because they have physical assets that need fire and police protection. But that is a question of the magnitude of benefits and the tax that is appropriate to finance them -- something that is properly addressed by the choice of apportionment formula and the tax rate, not the type of yes/no question that is relevant for issues of nexus. The answer must clearly be a resounding yes to the question of whether the state has given anything for which it can ask in return.

A second invalid argument relies on the Revolutionary War rallying cry "no taxation without representation." Opponents of tighter nexus rules suggest that those rules would violate the basic American principle that there should be no taxation without representation. That argument fails on several grounds. First, not all rallying cries of the Revolutionary War made their way into the Constitution. An inviolate link between the right to vote and the duty to pay tax is not among those that did. Individuals who lack the right to vote due to nonresidence are nonetheless (properly) taxable. Second, virtually all of the taxes under discussion here are (or would be, under a tighter nexus standard) paid or collected by corporations, not by individuals. Because corporations do not vote, this argument is something of a red herring. Beyond that, out-of- state taxpayers, whether actual or potential and whether corporations or individuals, have the same right to be represented by lobbyists as do in-state corporate and individual taxpayers. Indeed, corporate officials can probably do their own lobbying without

running afoul of existing nexus standards, let alone sensible ones. Thus, this charge lacks substance. Third, the same argument could be made against payment of property taxes. Finally, and most fundamentally, the type of taxation that would occur under sensible nexus rules would not discriminate against out-of-state business (something the U.S. Supreme Court would not countenance). Rather, sensible nexus rules would prevent discrimination in favor of out-of- state business by subjecting them to the same rules as in-state businesses, except as required to prevent excessive complexity. Even if it were true that out-of-state businesses had no representation, it is difficult to see the harm in requiring that they pay or collect the same taxes as their in-state competitors. (With uniform taxation, in-state businesses can be expected to help protect the interests of their out-of-state competitors in the political arena, because they will pay the same taxes.)

4. The issue of linkage. It has been suggested that enactment of the SSUTA and the BAT legislation should be linked -- that both are good, but neither should be enacted without the other.

It may sometimes be appropriate to link reforms. For example, it has long been recognized that it might be possible to link state action to simplify sales and use taxes with federal action to allow an expanded duty for remote sellers to collect use taxes, thereby reducing the adverse economic effects caused by the physical presence test of nexus, as well as complexity. That linkage is entirely appropriate, as the National Bellas Hess/Quill decisions were a response to the complexity of those taxes. It would not be appropriate to allow an expanded duty to collect in the absence of simplification, and true simplification, although desirable for its own sake, may occur only if the federal government holds out the "carrot" of an expanded duty to collect.

By comparison, the proposed linkage of SSUTA and the BAT legislation is only political; it has no inherent logic. It is intended (a) to create a quid pro quo for action on the two issues and (b) to allay fears that the lower nexus threshold for use taxes would seep over into a lower threshold for BATs. The second of those is more appropriately addressed by establishing the type of nexus standard based on the presence of apportionment factors described earlier.